No. [redacted] 80

MAY 16

IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

MURPHY OIL COMPANY, a Corporation,
Petitioner,

vs.

DAVID BURNET, Commissioner of Internal Revenue,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

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IN THE

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OCTOBER TERM, 1931.

No. .....

MURPHY OIL COMPANY, a Corporation,
Petitioner,
vs.
DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS, NINTH CIRCUIT.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Petitioner, Murphy Oil Company, a corporation, respectfully shows to this Honorable Court that this is a petition for a writ of certiorari to the Circuit Court of Appeals, Ninth Circuit, to review a decision made and entered by that Court on January 11, 1932 (R. II-296)*, reversing

* Since the record is a consolidation of the record in two appeals, there is a duplication of page numbers. Therefore the figure I is used where reference is had to the pages of the record in No. 6388 and the figure II is used where reference is had to the pages of the record in No. 6459.

on the issue involved a decision of the United States Board of Tax Appeals (R. I-61). Petitioner filed petition for a rehearing on February 8, 1932, which was denied on February 23, 1932 (R. II-297).

A.

Summary statement of the matter involved.

1. History of case.

This controversy was originated by a deficiency letter issued by the Commissioner of Internal Revenue dated February 6, 1926 (R. I-18), proposing a deficiency in income tax against petitioner for the years 1919 and 1920 amounting to $398,400.53 (R. I-18). Petitioner appealed to the Board of Tax Appeals which, on January 17, 1930, rendered its decision eliminating the deficiency proposed (R. I-62). Although the deficiency was eliminated the decision of the Board was in favor of the petitioner taxpayer on only one of the two issues contested before the Board, referred to herein as the bonus and expense points. The contentions of the taxpayer prevailed as to the bonus point and the contentions of the Commissioner prevailed as to the expense point.

Separate appeals were taken by the Commissioner and the taxpayer to the Circuit Court of Appeals, Ninth Circuit (R. I-62, II-253), and that Court on January 11, 1932, handed down decisions reversing the Board of Tax Appeals on the bonus point, involved in the case of *Murphy Oil Company* v. *David Burnet, Commissioner of Internal Revenue* (R. I-62), and affirming the Board on the expense point, involved in the case of *Commissioner of Internal Revenue* v. *Murphy Oil Company* (R. II-253), thus making

the ultimate decision on both points in favor of the Commissioner (R. II-296). Rehearing has been denied (R. II-297). The records in the two appeals have now been consolidated by the Clerk of the Circuit Court of Appeals. In order to simplify issues and present to this Honorable Court a clear-cut issue on the bonus point the taxpayer is abandoning its contentions on the expense point and is asking for a writ of certiorari only with respect to the bonus point. Therefore, such writ of certiorari is sought solely as to the case of *Murphy Oil Company* v. *David Burnet, Commissioner of Internal Revenue*, Docket No. 6388 (R. I-1).

2. Facts involved in bonus point.

Prior to March 1, 1913, the taxpayer petitioner acquired in fee two parcels of real estate in California, the Coyote and Whittier properties (R. I-47). Oil and gas were found upon the properties and on March 1, 1913, they were both producing. On December 1, 1913, the taxpayer leased the properties to the Standard Oil Company of California for a term of forty years for the purpose of developing and producing oil and gas (R. I-50). The lessor reserved a one-fourth royalty and the lessee agreed to and did pay in installments from 1913 to 1918, inclusive, and "independently of and in addition to royalties", a so-called bonus of $5,500,000.00. The bonus was not dependent upon production (R. I-59). Personal property was transferred in connection with the lease to which has been allocated $326,404.82, leaving a net bonus of $5,173,595.18 (R. I-51). The Commissioner has allocated this bonus between the properties, $4,517,402.70 to the Coyote property and $656,192.48 to the Whittier property (R. I-52).

Since the properties were acquired prior to March 1, 1913, the basis of the taxpayer for computing depletion is

the value on March 1, 1913. That value has been found by the Commissioner to be $15,710,899.52 for the Coyote properties and $1,450,207.08 for the Whittier properties, and is not in dispute (R. II-272).*

Pursuant to Article 215 (a) of Regulations 45 as then in effect (1920 edition) and before amendment by Treasury Decision 3938, C. B. V.—2, p. 117, this bonus was treated in the deficiency letter issued by the Commissioner as a return of capital and the entire bonus was applied in reduction of the value at March 1, 1913, as a basis for depletion (R. I-18). The petitioner appealed to the Board on the ground that the bonus was not a *return of capital* but was *income* (R. I-6). The Commissioner answered and the case was tried by both parties on the assumption that the issue was whether or not the bonus was a return of capital or income. Subsequent to the trial the Commissioner "confessed error" in his brief (R. I-58), changing his position in accordance with the then recently issued amendment of Article 215 (a) of Regulations 45 by Treasury Decision 3938, *supra,* which provided that bonuses were to be treated not as a return of capital but as income and that a certain amount of depletion, according to the formula provided in the amended regulation, should be allocated to the bonus income as received irrespective of when oil was produced from the properties. In its 1920 edition, Article 215 (a) of Regulations 45, before amendment by Treasury Decision 3938, *supra,* provided as follows:

---

* The Circuit Court of Appeals deals only with the Coyote property (see "Depletion Schedule", R. II-270), saying (R. II-271):

> "Hereinafter only the depletion of the Coyote property as affected by the portion of the bonus allocated to that property will be considered in detail, but the same principles are also applicable to the depletion of the Whittier property."

> "(a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition."

This language was revised by Treasury Decision 3938, *supra,* to read as follows:

> "(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received."

The contrast between these two editions of Article 215 (a) may be briefly illustrated in their applicability to the instant case. If a bonus is treated as a "return of capital to the lessor" naturally the lessor's capital sum returnable through depletion is reduced *in toto* by the amount of the bonus. This was done in the deficiency letter. On the

other hand, if a bonus is treated as "income" and a deduction for depletion is allowed "in respect of the bonus", as in the amended article, the capital sum remaining at the beginning of taxable years after the bonus has been received has been reduced by whatever amount of depletion has been so allocated to and allowed in respect of the bonus. Thus, the capital sum at the beginning of the taxable year is reduced without a correlative reduction of reserves and the depletion unit per barrel is accordingly reduced. The effect is, of course, to lower the depletion allowance in the taxable year.

For example, if a capital sum returnable through depletion is allowed of $1,000,000 with a mineral reserve of 2,000,000 barrels, the depletion unit is $0.50 per barrel. As production takes place both the mineral reserve and the capital sum returnable through depletion is reduced. If a bonus of $200,000 is received and there is allocated to the bonus depletion of $100,000, the capital sum is reduced to $900,000, without a correlative reduction of the reserves; thus the taxpayer's depletion unit instead of being $0.50 per barrel, is reduced to $0.45 per barrel—$900,000 divided by 2,000,000 barrels.

The Board held that the revised regulation was invalid (R. I-60). It likewise impliedly rejected the principle of the earlier regulation. It sustained the petitioner's method of computing depletion. In reversing the Board of Tax Appeals the Circuit Court of Appeals approved the amended regulation and its principle of offsetting depletion against the bonus on the theory that the bonus was *in part* a return of March 1, 1913, value and *in part* taxable income (R. II-290). Inasmuch as the theory of the amended regulation was raised by the Commissioner in his

brief filed subsequent to the trial, no opportunity has ever been furnished for the submission of the proof necessary to determine the amount of the bonus which should be deducted pursuant to the amended article and under the decision of the Circuit Court of Appeals. The effect of the decision of the Circuit Court of Appeals is to affirm the deficiency originally proposed of $398,400.53. The deficiency, as computable under the formula prescribed in the amended regulation approved by the Circuit Court of Appeals, would undoubtedly be different. The result is an affirmance of the admittedly erroneous deficiency proposed by the Commissioner in his deficiency letter (R. II-291).

3. Question involved.

The bonus point involves the meaning of the word "depletion" as used in Sections 214(a) (10) and 234(a) (9) of the Revenue Act of 1918, which provide:

> "Section 234(a)—That in computing the net income of a corporation subject to the tax imposed by Section 230, there shall be allowed as deductions:
>
> * * *
>
> "(9) in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion * * *".

(Section 214(a) (10) is identical in language.)

The question involved therefore is whether a bonus paid to the taxpayer for entering on December 1, 1913, into a lease of its oil properties, should be applied in reduction of the depletable base of the taxpayer with respect to the property leased, viz., in the instant case value at March 1, 1913. This question resolves itself into a question whether

depletion, which would be allowable to the taxpayer in the years 1919 and 1920, on a production or exhaustion basis, may be transferred to the prior years in which the bonus was received. Article 215(a), as amended, by Treasury Decision 3938, *supra,* and as approved by the Circuit Court of Appeals, provides that depletion may be transferred or allocated in accordance with income received and the validity of the amended article is therefore brought into issue. The really basic question is whether depletion in a given taxable year is to be determined by reference to the measuring rod of income received or by reference to the exhaustion or depletion of the property in the year—on a dollar or a barrel basis.

B.

Reasons for granting the petition.

(1) In its approval of Article 215(a), as amended by Treasury Decision 3938, *supra,* the opinion of the Circuit Court of Appeals is erroneous and in conflict with the decision of this Honorable Court in the case of *Burnet* v. *Thompson Oil & Gas Co.,* 283 U. S. 301, in that Article 215(a), as so amended, proposes by the mechanism of reducing the taxpayer's capital sum returnable through depletion, to transfer depletion properly allowable in 1919 and 1920, when oil was produced, to prior years when income in the form of a bonus was received.

Depletion means actual exhaustion of the depletable property. The statutory allowance for depletion is to be accorded only as actual exhaustion takes place. Article 215(a), as amended, allows a depletion "in respect of the

bonus'' of ''an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received''.

This formula disregards exhaustion of the property altogether as determining the amount of depletion. The result of the application of the formula is to determine the depletion deduction upon an *income* basis. It is established that bonuses are income. In its approval of the amended regulation, the decision of the Circuit Court of Appeals is, in principle, applicable not only to depletion in cases involving a bonus, but to depletion in cases in which no bonus is involved. It is also applicable to other statutory deductions such as depreciation, obsolescence and losses. The decision is, therefore, in conflict (a) with the basic statutory concept that these deductions for any particular year should be determined by what happens to the property in that year and not by the amount of income received in any year, and (b) with the decisions of other Circuit Courts of Appeals, particularly the Eighth Circuit, in *Kansas City Southern Ry. Co.* v. *Commissioner,* 52 F. (2d) 372 (C. C. A. 8th), certiorari denied 284 U. S. Advance Sheets, Part 2, Page VIII. The decision strikes at the heart of the basic concept of several of the statutory deductions and disregards as well the established concept of the taxable year as a unit of time. It is from this radical interpretation of the unambiguous word ''depletion'', as used in the statute, that an appeal is desired. If a decision so upsetting established concepts and practice is not reviewed, great confusion will result in the minds of millions of taxpayers and in the administration of the income tax.

(2) The Circuit Court of Appeals has erroneously construed, and its decision is in conflict with the decision of this Honorable Court in *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, in that it reasons from that case that the depletable base of the taxpayer as lessor and the depletable base of the taxpayer's lessee, the Standard Oil Company, cannot exceed the value at March 1, 1913, of the taxpayer's properties. The decision in the *Alworth-Stephens* case, *supra,* did not involve, as does the instant case, a lease made after February 28, 1913. The statute plainly provides that the depletable base of the lessor in such a case shall be the value of its property at March 1, 1913, and that the depletable base of the lessee shall be the cost of its property. There is absolutely no provision for deducting the lessee's cost from the lessor's base, value at March 1, 1913, on account of a lease made *after* that date and the receipt of a bonus in connection therewith.

(3) The Circuit Court of Appeals opinion is contradictory in asserting the validity of Article 215(a), as amended; and in suggesting the division of the value at March 1, 1913, between lessor and lessee, which division it presumes to be required by the *Alworth-Stephens* case, *supra.* Article 215(a) as amended does not purport to reduce the lessor's capital sum returnable through depletion. It simply provides for the distribution of the entire capital sum returnable through depletion over the years in accordance with a formula based upon the receipt of income, as distinguished from exhaustion of the property.

(4) The decision of the Circuit Court of Appeals is in conflict with the decision of the Circuit Court of Appeals for the Fourth Circuit in *Underwood* v. *Commissioner,* 56 F. (2d) 67, with the decision of the Court of Appeals of

the District of Columbia in *Dempster Mill Mfg. Co.* v. *Burnet*, 46 F. (2d) 604, and with the decision of the Circuit Court of Appeals for the Fifth Circuit in *The Alger Sullivan Lumber Company* v. *Commissioner*, 1932, Commerce Clearing House, Standard Federal Tax Service, paragraph 9194 (not yet elsewhere reported), in that the court failed to remand the case tried below upon an assumption presented by the pleadings (the Commissioner's deficiency letter, the taxpayer's petition to the Board of Tax Appeals and the Commissioner's answer thereto) and shared by both parties as to the issue involved, which assumption was departed from by the Commissioner after the trial before the Board.

Both parties shared the view at the trial that the only question for determination was whether the instrument of December 1, 1913, pursuant to which the bonus was paid to the taxpayer, was an agreement of sale or lease. It was asserted by the deficiency letter to be an agreement of sale so that the bonus was a return of capital. The deficiency letter was based upon the then outstanding 1920 edition of Article 215 (a) of Regulations 45. The taxpayer contended that the instrument was a lease and that the entire bonus was income. The position of the Commissioner, taken after the Board hearing, upon the basis of the amended edition of Article 215 (a), was that depletion should be allocated to the years in which the bonus was received, as distinguished from the years in which depletion was sustained. It was this latter position which was approved in principle by the Circuit Court of Appeals.

This disposition of an important case, on grounds not in the minds of the contending parties and reaching a result admittedly erroneous, raises grave problems of practice and procedure involving upwards of seventeen

thousand cases now pending before the Board. These problems should and can be settled only by this finally authoritative tribunal. It is a matter of prime concern to thousands of taxpayers to know whether the burden-of-proof rule, to use the language of the Court in the *Underwood* case, *supra*, goes to the extent of requiring the Board or Courts to "countenance" such an "obvious injustice" as is involved in the decision of the Circuit Court of Appeals in the instant case.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari be issued out of and under the seal of this Honorable Court, directed to the United States Circuit Court of Appeals for the Ninth Circuit commanding that Court to certify and send to this Court for its review and determination, on a day certain to be therein named, a full and complete transcript of the record of all proceedings in the cases numbered and entitled Docket No. 6388, Murphy Oil Company, a Corporation, Petitioner, v. David Burnet, Commissioner of Internal Revenue, Respondent, and Docket No. 6459, David Burnet, Commissioner of Internal Revenue, Petitioner, v. Murphy Oil Company, a Corporation, Respondent, and that the judgment of the Circuit Court of Appeals, Ninth Circuit, in Docket No. 6459 may be reversed by this Honorable Court, and the decision of the Board of the Tax Appeals be reinstated and affirmed, and that your Petitioner may have such other and further relief in the premises as to this Honorable Court may seem meet and just; and your petitioner will ever pray.

MURPHY OIL COMPANY,
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New York City.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. .....

MURPHY OIL COMPANY, a Corporation,
Petitioner,
vs.
DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS, NINTH CIRCUIT.

I.

Opinion Below.

The opinion of the Circuit Court of Appeals, Ninth Circuit, is reported in 55 F. (2d) 17.

II.

Jurisdiction.

The jurisdiction of this Court is involved on the following grounds:

(1) The judgment to be reviewed was originally entered January 11, 1932 (R. II-268). The taxpayer filed a petition for rehearing which was submitted on February 8, 1932, and denied February 23, 1932 (R. II-297). Time to apply for a writ of certiorari, therefore, runs from February 23, 1932. (*Citizens' Bank of Michigan City* v. *Opperman*, 249 U. S. 448, 450; *Morse* v. *United States*, 270 U. S. 151, 153).

(2) The Board of Tax Appeals had jurisdiction of this case under Section 274(a) of the Act of Congress, approved February 26, 1926, entitled the "Revenue Act of 1926" (44 Stat. 55; 26 U. S. C. A., Sec. 1048). The appeals to the Circuit Court of Appeals were taken in pursuance of the provisions of Sections 1001, 1002 and 1003 of the Act of Congress approved February 26, 1926, entitled the "Revenue Act of 1926" (44 Stat. 1, 109, 110; 26 U. S. C. A., Sections 1224, 1225, 1226), as amended by Section 603 of the Act of Congress approved May 29, 1928, entitled the "Revenue Act of 1928" (45 Stat. 873, 26 U. S. C. A., Section 1224).

(3) This Court has jurisdiction to review the judgment of the Circuit Court of Appeals. *Old Colony Trust Company et al., Executors* v. *Commissioner*, 279 U. S. 716.

III.

Question involved.

The question immediately presented by the decision of the Circuit Court of Appeals in the instant case is whether the taxpayer's capital sum for purposes of depletion in the years 1919 and 1920 should be reduced by a bonus received by the taxpayer in previous years for entering on December 1, 1913, into a lease of its oil properties. This question resolves itself into a question whether depletion, which would be allowable to the taxpayer in the years 1919 and 1920 on the production basis, may be transferred to prior years when the bonus was received. The fundamental question is, therefore, whether Article 215(a) of Regulations 45, as amended by Treasury Decision 3938, C. B. V-2, p. 117, is valid and in conformity with the Statute in determining the amount of depletion in any year in which a bonus is received by reference to the income of that year and not by reference to the exhaustion or depletion of the property in that year.

IV.

Assignments of error.

(1) The Circuit Court of Appeals erred in holding that the taxpayer's capital sum for purposes of computing depletion in the years 1919 and 1920 should be reduced by a bonus received in previous years.

(2) The Circuit Court of Appeals erred in holding that any part of the depletion allowance of the taxpayer, com-

putable upon a production or exhaustion basis for the years 1919 and 1920, should be transferred to previous years when the taxpayer received a bonus for entering into a lease of its oil properties.

(3) The Circuit Court of Appeals erred in holding that Article 215(a) of Regulations 45, as amended by Treasury decision 3938, *supra,* is valid and in conformity with the Statute.

(4) The Circuit Court of Appeals erred in holding that the word "depletion", which, as used in the Revenue Act of 1918, means actual exhaustion of properties, may be determined on the basis of income received, as distinguished from exhaustion or reduction of mineral reserves.

(5) The Circuit Court of Appeals erred in holding that in the case of a lease entered into after February 28, 1913, the total depletable interest of the lessor and lessee might not exceed the value of the properties at February 28, 1913, when there was no sale of the properties.

(6) The Circuit Court of Appeals erred in holding that the burden-of-proof rule precluded the remanding of the case for further evidence where the record was complete on the theory of the case and issue stated in the pleadings before the Board of Tax Appeals (deficiency letter, taxpayer's petition, and the Commissioner's answer), but was not complete on a theory of the case advanced by the Commissioner for the first time after the trial thereof. The burden-of-proof rule does not go further than to require the taxpayer to sustain the burden of proof with respect to the issue presented by the pleadings and shared by the litigants at the trial.

V.

Argument.

A.

Depletion means actual exhaustion of the depletable property and (1) should be allowed only as actual exhaustion takes place, and (2) should not be allocated to particular taxable years by means of a formula based upon receipt of income.

The instant case involves a problem of depletion. The statutory provision requiring interpretation is as follows:

> "Section 234(a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * *
>
> "(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion * * *."

The question involved, simply stated, is whether under this provision (Sec. 234 (a) (9) of the Revenue Act of 1918) a depletion allowance may be made to a lessor of oil properties in respect to a bonus received and without reference to the amount of oil taken from the properties. What is the meaning of the word "depletion" as used in the statute? The word is wholly unambiguous and has been repeatedly defined by this Honorable Court and other authorities.

The noun "depletion" is defined in Webster's New International Dictionary as "Act of depleting; a state of being depleted".

The verb "deplete", according to the same authority, means: "to reduce by destroying or consuming the vital powers of; to exhaust, as a country of its strength or resources, a treasury of money, etc."

In *United States* v. *Ludey*, 274 U. S. 295, 302, this Court, referring to the depletion provision, said:

> "The depletion charge * * * represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment."

Again in *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364, 369, this Court said:

> "In the case of mines, a specific kind of property, the exhaustion is described as depletion, * * *. The interest of respondent under its leases in the mines being property, its right to deduct a reasonable allowance for exhaustion of such property, if there be any, during the taxable year, results from the plain terms of the statute, such deduction, since the property is an interest in mines, to be limited to the amount of the exhaustion of respondent's interest caused by the depletion of the mines during the taxable year We agree with the circuit court of appeals * * * that 'The plain, clear, and reasonable meaning of the statute seems to be that the reasonable allowance for depletion in case of a mine is to be made to every one whose property right and interest therein have been depleted by the extraction and disposition "of the product thereof which has been mined and sold during the year for which the return and computation are made". * * *'"

A. R. R. 1147, C. B. I-2, p. 138 and A. R. M. 148, C. B. I-1, p. 186, adhere to the definition of depletion contained in the above authorities. In the latter of the two rulings it is said at p. 187:

> "* * * Where no mineral is produced upon the premises it follows that the interest of the taxpayer in the mineral reserves is not affected and that no allowance can be made for depletion."

Under the accepted definition of the word "depletion" the *sine qua non* of any allowance is the exhaustion of taxpayer's reserves. If there is no exhaustion, there can be no depletion and there is no authority for an allowance therefor. The depletion of the taxpayer's properties in the instant case was not a condition to the payment of the bonus. The bonus was paid without reference to the exhaustion of the taxpayer's properties and it is against the plain meaning of the statutory provision and the authorities defining depletion to allow depletion in respect of a bonus which has no reference whatever to production. This was distinctly recognized by the Board and forms the basis of its decision, as indicated by the following quotation from its opinion (15 B. T. A. 1195, at 1203) (R. I-59):

> "The bonus payment in the instant case was a part of the consideration paid for the lease. While expected production undoubtedly was considered in fixing the amount of the bonus, it is elementary under the laws governing such agreements that its payment did not, in anywise, depend upon, or relate to, production. The lessee's liability therefore was fixed by the terms of the contract. On the other hand, the operation of the principle of depletion depends upon exhaustion of resources through production—i.e., the recovery of capital through its con-

> version from the form of oil resources or reserves into marketable products or the equivalent received for such product. Under such principle the depletion allowance for the year or years of the bonus payments can only be measured by reference to the oil produced. If, as we have pointed out, the bonus is income, no part of which represents recovery of capital, it follows that any depletion allowance against such income is a departure from the depletion concept. The regulation relied on by the respondent is clearly such a departure."

The opinion of the Circuit Court of Appeals in the instant case is not altogether easy to follow, but the effect is to approve the regulation of the Commissioner allocating depletion to a bonus received in connection with an oil lease. This is indicated by the following quotation from page 25 (R. II-290):

> "The regulation is not only not in conflict with the statute, but directly conforms thereto."

The reference to the regulation so held to conform to the statute is to Regulations 45, Article 215(a), as amended on November 13, 1926, by Treasury Decision 3938, *supra*. As so amended, the regulation provides (italics ours):

> "(a) Where a lessor receives a bonus in addition to royalties, *there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received.* Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received."

Before amendment Article 215(a) in its 1920 edition provided (italics ours):

> "(a) Where a lessor receives a bonus or other sum in addition to royalties, *such bonus or other sum shall be regarded as a return of capital to the lessor,* but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition."

This regulation, as amended on November 13, 1926, represents the second change of mind and third attempt of the Commissioner to deal with this subject. Originally, prior to the promulgation of the 1920 edition of Regulations 45, the Commissioner ruled that bonuses were income. When he promulgated Article 215(a) of Regulations 45, 1920 edition, the Commissioner changed his mind and ruled that a bonus "shall be regarded as a *return of capital* to the lessor". On November 13, 1926, the Commisisoner again changed his mind, and ruled in Treasury decision 3938, *supra,* amending Article 215(a) of Regulations 45, that a bonus was *income;* but in this regulation the Commissioner added to his conception of a bonus as income an entirely new conception—that a depletion deduction should be allowed "in respect of the bonus" equal to the "proportion of the cost or value of the property on the basic date which the

amount of the bonus bears to the sum of the bonus and royalties expected to be received."

The expression "royalties expected to be received" deserves some parenthetical comment. It may be possible under certain mineral leases to determine with reasonable accuracy on a dollar basis the royalties to be expected over the life of the property or the term of the lease. But the lease involved in the instant case is an oil lease and any estimation of royalties to be expected involves the determination of highly problematical factors such as future price of oil over a long period—in the instant case forty years. This Honorable Court will recognize the highly speculative character of any estimate or prophecy of the amount of royalties to be expected by this taxpayer; to express the amount in dollars involves almost insuperable difficulties of proof; indeed, it is extremely doubtful whether future royalties are susceptible of proof. See *Burnet* v. *Logan*, 283 U. S. 409, 412. This would indicate that the regulation, as amended, is so arbitrary and capricious that it is beyond the scope of the Commissioner's power which is limited to authority to make reasonable regulations. However, the fundamental question is: *Must depletion be computed and allowed on the basis of income received, or on the basis of the actual exhaustion of the properties?*

It is not specifically said, but it is, of course, implied in the amended regulation that a bonus is income. That it is income is absolutely settled.* What causes the difficulty in

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* *Alexander* v. *King*, 46 F. (2d) 235 (C. C. A. 10th), reversing 38 F. (2d) 256; *Berg, et ux.* v. *Commissioner*, 33 F. (2d) 641 (Ct. of App. D. C.), affirming (6 B. T. A. 1287), *certiorari* denied, 280 U. S. 598; *Burkett* v. *Commissioner*, 31 F. (2d) 667 (C. C. A. 8th), affirming 7 B. T. A. 560, *certiorari* denied, 280 U. S. 565; See also *Weiss* v. *Wiener*, 279 U. S. 333, reversing 27 F. (2d) 200 (C. C. A.

the instant case is not the question whether a bonus is income, but whether a depletion deduction shall be allowed in respect of the bonus (the payment of which in the instant case was not dependent upon production) and without reference to the exhaustion of the depletable property. In other words, the whole issue is whether depletion shall be deducted as and when a bonus is received and wholly independently of production from or exhaustion of the property—or as and when the mineral reserves are taken from the property, and converted into marketable products. The real question is whether depletion is to be allocated to years when income is received, or to the years when the property suffers depletion.

It does not require any elaborate discussion to point out the far-reaching effects of a decision that depletion is to be deducted, as the Circuit Court of Appeals has decided, not as it occurs, but as income is received from the depletable property. The uniform practice of the Commissioner has been to calculate depletion for each annual period, not on a *dollar* basis, according to the income from the property, but on a *barrel* basis, according to the amount of mineral taken from the property. It is only when bonuses are received in connection with *mineral* leases that the Commissioner indulges in the strange departure from his usual practice, and from the concept of the statute.

If depletion is to be allocated in accordance with income, there is absolutely no reason for differentiating between

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6th), reversing 17 F. (2d) 650; *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, reversing 219 Fed. 31 (C. C. A. 8th); *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103; *Stratton's Independence, Ltd.* v. *Howbert*, 231 U. S. 399, affirming 207 Fed. 419; *Rosenberger* v. *McCaughn*, 25 F. (2d) 699 (C. C. A. 3rd), *certiorari* denied, 278 U. S. 604; *New Creek Co.* v. *Lederer*, 295 Fed. 433.

leases involving bonuses and those which do not. A bonus does not differ from ordinary royalties in being income; both are income; the bonus in the instant case differs from the ordinary royalty only in that it was payable whether or not there was any production from the property and whether or not the lessee entered upon the property. The allocation of depletion to a bonus by the formula provided in Article 215(a), as amended, amounts to the allocation of depletion in accordance with income and not in accordance with the exhaustion of the reserves in the depletable property. The generic vice of the amended regulation is in using income as a measuring rod of annual depletion instead of the exhaustion of the property. The receipt of income does not vary year by year solely in accordance with the exhaustion of the property; other factors intervene, such as the price of oil and the cost of extracting the oil.

Since bonuses and ordinary royalties are both income the method used in Article 215(a), as amended, is, in principle, equally applicable, if sound, to all depletion. That being so, depletion should be measured by dollars (income basis) rather than by barrels (exhaustion basis) regardless of whether a bonus is involved.

If depletion should be computed on the dollar basis, depreciation, which is essentially the equivalent of depletion,* should also be computed on a dollar basis according to income and not according to exhaustion of the property. It follows from this radical doctrine that every depletion and every depreciation allowance ever computed by the Commissioner is wrong. He should recompute all depletion and depreciation allowances, spreading them over the

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* In *United States* v. *Ludey*, 274 U. S. 295, 303, this Honorable Court has said: "In essence, the deduction for depletion does not differ from the deductions for depreciation."

years in proportion to the income received each year. In this fundamental sense Article 215 (a), as amended, is a revolutionary departure from the concept of the statute and from the otherwise unvaried practice of the Commissioner.

What has been said with respect to depreciation applies equally to obsolescence and losses—all the deductions which are allowed to the taxpayer as a compensation for the exhaustion of property used in the production of income.

It was attempted by the taxpayer in *Kansas City Southern Railway Company* v. *Commissioner,* 52 F. (2d) 372 (C. C. A. 8th), certiorari denied 284 U. S. Advance Sheets, Part 2, Page VIII, to secure a deduction in 1918 and 1919 for obsolescence of a building which, as the Court observes, "occurred prior to 1913". The Circuit Court of Appeals for the Eighth Circuit showed throughout its opinion its clear understanding of the statutory concept of depreciation and obsolescence. The concept is that income must be taxed on an annual basis and that the deductions are permissible only on account of something happening in the year, something apart from the mere receipt of income. The Court said at page 376:

> "The rule as to allowance for exhaustion, wear, and tear of property used in the trade or business is the same as the rule concerning obsolescence. We think no case can be found holding that exhaustion, wear, and tear of former years may be carried over and deducted in arriving at the income in some subsequent year. A loss attributable to a particular year is a loss occurring by reason of something happening in that year. It is not given to parties to make choice as to the years in which they will take reductions."

In the case of depreciation there must be, under the doctrine of the *Kansas City Southern* case, a diminishment of the properties, an exhaustion of that which produces the income. This decision of the Circuit Court of Appeals for the Eighth Circuit is simply irreconcilable with the decision of the Ninth Circuit in the instant case.

This Honorable Court has passed only once on the question of precisely how depletion shall be computed. The Board of Tax Appeals stated the rule with absolute clearness in *Thompson Oil & Gas Co.*, 15 B. T. A. 993, affirmed by this Court in 283 U. S. 301. The Board said at page 997, (italics ours):

> "That a reasonable allowance for the depletion of a wasting or exhaustible asset, such as we have here, will be obtained by considering that the recoverable value will *become exhausted in the same ratio as that which gives value to the asset disappears,* can hardly be questioned. *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364. For example, if at January 1, 1917, a taxpayer had purchased a leasehold for the recovery of oil at a cost of $100,000 with oil to be recovered of 400,000 barrels, and if, during 1918, 100,000 barrels had been produced, a depletion allowance of $25,000, or 25 cents per barrel would certainly be accepted as the reasonable depletion allowance for 1918."

This Court, in affirming this decision, stated that the question involved was whether in determining depletion under the 1918 Act there should be deducted from the capital sum, *viz.*, the capital value recoverable through depletion, depletion actually sustained in earlier years or only so much of that depletion as was allowable as a deduction under revenue acts in force in earlier years. The de-

duction *permitted* for earlier years fell about $85,000 short of the *sustained* depletion—the amount by which the reserve was exhausted. The taxpayer argued that only the depletion *allowed* should be used to reduce the capital sum. The Commissioner argued that the entire amount *sustained* should reduce the capital recoverable.

Analyzing the contention of the taxpayer, this Court held that it was in effect trying to make up in 1918 for the depletion sustained but not allowed in earlier years as a deduction—that it was attempting in 1918 to obtain a deduction for depletion not *sustained* in 1918. The court held emphatically that only the sustained depletion of 1918 was allowable, saying at page 306:

> "The tax is an income tax for 1918, and in the absence of express provision to the contrary, it is not to be supposed that the taxpayer is authorized to deduct from that year's income, depreciation, depletion, business losses or other similar items attributable to other years. * * * The construction adopted by the court below in effect results in including in the taxable year items referrable to other years, and is contrary to the theory of a tax for specific years.
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> "The nature of the tax as one for annual periods has been repeatedly mentioned in dealing with its application in various situations. The taxable year 1918, and that only, is involved, and deductions applicable to that year only should be allowed."

This Court, in thus refusing the taxpayer in the *Thompson* case the deduction of depletion not sustained in the taxable year, announced a principle which is conclusive of the real issue in the instant case. Depletion should be taken and measured by that sustained.

The Revenue Act of 1918 grants in Section 234 (a) (9) a reasonable allowance for depletion. It is true that the allowance of depletion is a matter of legislative grace.* Congress might grant any allowance it pleased or none at all. But once Congress has legislated, giving a deduction in unambiguous terms by the use of the word "depletion," there can be no excuse for departing from the conception of the statute. The fact that the allowance of depletion is a matter of legislative discretion does not mean that the Commissioner, in interpreting the statute, may exercise a discretion which contravenes the statute. Nothing can be substituted for the will of Congress as clearly expressed. The word "depletion" is unambiguous. It stands for a fact, an exhaustion which happens to the property in the taxable year. If then no depletion happens in the year, no depletion can under the statute be allowed; if it does happen, depletion cannot legally be shifted to other years. It is a perversion of the statute and a denial of the will of Congress to allow or deny depletion according to the wholly irrelevant existence or nonexistence in a year of a bonus, or any other type of income.

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* *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, reversing 40 F. (2d) 493 (C. C. A. 10th), which reversed 15 B. T. A. 993; *United States* v. *Biwabik Mining Co.*, 247 U. S. 116; *Stratton's Independence, Ltd.* v. *Howbert*, 231 U. S. 399, affirming 207 Fed. 419; *Pugh, et al.* v. *Commissioner*, 49 F. (2d) 76 (C. C. A. 5th); *Merle-Smith* v. *Commissioner*, 42 F. (2d) 837 (C. C. A. 2nd), *certiorari* denied, 282 U. S. 897.

B.

The decision of the Circuit Court of Appeals misapplies the decision of this Honorable Court in *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364.

The opinion of the Circuit Court of Appeals is so difficult to follow that it may clarify the real issue involved to refer to some further errors which may contribute to the utimate error of that Court.

The opinion discusses the bonus question both on principle and on authority (R. II-272-276). The conclusion reached "on principle" is to the effect that the fee valuation of $15,710,899.52 represented the total combined interest at March 1, 1913, of the taxpayer, as lessor, and of the lessee, and that no greater sum should be depleted (R. II-272). It is said that: "The allowance of the total depletion to the lessor, as was required by the decision of the Board of Tax Appeals, left nothing to be apportioned to the interest of the lessee in the property" (R. II-282). In support of this conclusion Section 234 (a) (9) of the 1918 Act, and also Section 214 (a) (10) of that Act, are referred to, particularly the last sentence, to the effect that the depletion deduction "shall be equitably apportioned between the lessor and lessee" (R. II-282).

To interpret the apportionment clause the Circuit Court of Appeals refers to the case of *Lynch* v. *Alworth-Stephens Co.*, 267 U. S. 364 (R. II-281), placing particular emphasis on that part of the opinion of this Court, wherein it was stated:

> "* * * There is an exhaustion of property in the one case as in the other; and the extent of it, *with the consequent deduction to be made, in each case is*

> *to be arrived at in the same way, namely, by determining the aggregate amount of the depletion of the mines in which the several interests inhere, based upon the market value of the product, and allocating that amount in proportion to the interest of each severally considered.* Pages 369, 370 of 267 U. S., 45 S. Ct. 274, 275, 69 L. Ed. 660. (Italics ours)"

The decision that not more than $15,547,522.17* should be depleted after November 30, 1913, by lessor and lessee cannot be reconciled with the later conclusion of the opinion that Article 215 (a) of Regulations 45, as amended, is valid (R. II-290). That regulation, to put it simply, permits depletion *to the lessor* with respect to the *entire* March 1, 1913, value. It rules that the value at March 1, 1913, allowable in full as depletion to the lessor, should be applied in part against the bonus by providing that the lessor shall be entitled to deduct "that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and royalties expected to be received". Article 215 (a) simply deals, and makes no attempt to do anything more than deal, with the *distribution of depletion* over the years.

Since the lessee is by the statute and the regulations permitted depletion of the cost where the lease is entered into subsquent to February 28, 1913, the depletion in the instant case under the regulations, approved by the Circuit Court of Appeals, must equal $15,710,899.52 allowed to the lessor and $4,517,402.70 allowed the lessee, or a total of $20,228,302.22.

Thus, the conclusion of the Circuit Court of Appeals that Article 215 (a), as amended, conforms to the statute

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* This is the value at March 1, 1913, $15,710,899.52 (Coyote property), depleted to December 1, 1913, the date of the lease. See footnote, page 4.

is wholly inconsistent with its reasoning that not more than the total basic value at March 1, 1913, should be deducted by lessor and lessee.

As has been pointed out, the Circuit Court of Appeals refers to the so-called "apportionment" clause of the depletion provision in support of its conclusion that not more than $15,547,522.17 may be depleted after November 30, 1913. The clause provides that "in the cases of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *." The opinion of the Circuit Court of Appeals at pages 20-21 of 55 Federal Reporter, Second Series, (R. II-276) shows the basic misapprehension under which it was laboring when it says that land worth $15,547,522.17 could not be sold for more subject to the lease than $11,030,119.47 (the value at December 1, 1913, less the bonus) "which represented his (the taxpayer's) capital investment in the recoverable royalty oil. It would seem then that the interest of the landlord in the royalty oil at the surface would be his proportion of the recoverable content of 10,190,814 barrels at a price to equal $11,030,119.47, which would be $1.08236 per barrel" (R. II-276).

This quotation indicates an opinion that the bonus was entirely a return of capital, which was the issue tried before the Board and which was raised by the deficiency letter, the petition and the Commissioner's answer thereto. Later in its opinion the Circuit Court of Appeals holds that the bonus is *in part* income and *in part* a return of capital (R. II-290). These inconsistent views reflect a failure to distinguish between a return of capital in the *ordinary* sense and a return of capital in the *statutory* sense. Any property subject to a lease might be worth less than the same property clear of a lease; the lease involves a surrender of an interest in

the property less than the whole interest. But such a surrender does not make the rentals or royalties under the lease any the less income, or in any sense reduce the basis or amount which the taxpayer may deduct by way of depletion or depreciation on account of the ownership of the property. The only way in which that statutory basis can be reduced is to sever from the taxpayer the title to part of the property, to transfer all or part of the basic underlying interest. Since depletion is a matter of legislative discretion,* a return of capital in the statutory sense has nothing to do with the return of capital in the ordinary sense. The only way in which the statute calls for a return of capital under these circumstances is through gradual exhaustion of the property. Such return is accomplished through the statutory allowance for depletion based on the actual annual exhaustion of the properties.

The last quotation from the opinion of the Circuit Court of Appeals to the effect that land worth $15,547,542.17 could not be sold for more subject to the lease than $11,030,119.47 is unobjectionable as a statement of fact, if it is meant that the taxpayer's residual or underlying interest might not be saleable for more than the lower figure. Of course, this assumption is unwarranted, for there is no reason why the property may not have appreciated in value between March 1, 1913, and December 1, 1913, when the lease was made. However, whether the property appreciated or depreciated in value, the execution of a lease does not affect the statutory basis for depletion or depreciation. If the owner of a city office building having a depreciable base of $1,000,000 should lease the building for a term of years, receiving on the execution of the lease a bonus of $500,000.00, the owner

* See cases cited in footnote 1, page 28.

would not be required nor permitted to reduce his depreciable base. His depreciable base would remain stationary. The $500,000 bonus would be income of the year of receipt or accrual and the only offset would be the statutory allowance for depreciation, which would be measured by the wear and tear of the building during the year. Of course, the fee owner's interest in the building might not be saleable for as much subject to a lease as clear of a lease, but that does not affect in the slightest degree the basis provided by the statute which may be returned over the life of the property free from tax. There is no way by which that base may be reduced short of a sale of the property or by actual wear and tear which is compensated for by the depreciation allowance.

It is respectfully urged that the decision of the Circuit Court of Appeals, based so largely on the decision of this Court in the *Alworth-Stephens* case, reflects an incorrect application of the true meaning of that decision. It is unnecessary to review to this Honorable Court the situation presented by the *Alworth-Stephens* case. The question presented was whether lessees were entitled under the 1918 Act to depletion based upon value at March 1, 1913. It was held that where the lease was entered into *prior* to March 1, 1913, and *was in effect on that date* the total interest therein was to be divided between the lessor and lessee and that the value at March 1, 1913, of the lessee's interest therein was depletable. As this Court well knows, its theory was that although the lessee might not have acquired the minerals in place, his privilege was a property right at March 1, 1913, the value of which should be returned to the lessee by the depletion allowance or otherwise.

The language of this Honorable Court in the *Alworth-Stephens* case, italicized in the Circuit Court of Appeals' opinion in the instant case, should of course be interpreted in the light of the problem before the Court and the decision and the significance of the italicized words should be limited to cases dealing with *the apportionment of March 1, 1913, value* between a lessor and a lessee when the lease was entered into *prior to and existed on that date.* There is no question in the instant case as to apportionment of value at March 1, 1913, between lessor and lessee because there were not at that date a lessor and lessee. There was simply a fee owner, the taxpayer. The lease involved in the *Alworth-Stephens* case was dated long before March 1, 1913. The facts of the *Alworth-Stephens* case do not support a conclusion that the capital sum of a fee owner returnable through depletion should be reduced in cases in which a fee owner leased property *subsequent* to February 28, 1913.

The statute prescribes "cost" as a general basis for depletion in the first part of subdivision (9) of Section 234(a). This provision gives the basis for the lessee's depletion. The first proviso has nothing to do with the lessee in the instant case because its property was not "acquired prior to March 1, 1913". This proviso does, however, apply to the taxpayer because it had acquired its properties in 1904. The proviso plainly establishes as the basis of the taxpayer's depletion *in lieu of the cost* in 1904, or up to March 1, 1913, "the fair market value of the property (the taxpayer's interest therein)" on March 1, 1913, which is conceded to be $15,710,899.52.* "The taxpayer's interest therein" was the *entire* interest in the property at that date. There was no

* For the Coyote properties only. See footnote 1, page 4.

interest in any other person. The lessee did not acquire its interest until several months later.

There were not two or more interests at March 1, 1913, among which the value at that date could be apportioned. There is nothing in the statute from which it can even be implied that the value of a taxpayer's interest at March 1, 1913, should be reduced because the taxpayer *subsequently* leases property and the lessee acquires a basis by reason of his payment.

The results of such a doctrine would be astonishing. Taxpayers owning property on March 1, 1913, should reduce the basis or capital sum returnable through depletion or depreciation in all cases in which any lease or license is given after that date, whether or not a bonus is received. It is respectfully submitted that in no case should the basis for depletion or depreciation be reduced on account of the receipt of *income*; the reduction is justified only when *capital* is returned. In the absence of sale capital is not returned except as the statute provides. The statute provides that it shall be considered as returned under the depletion allowance when the depletion is sustained.

The *Alworth-Stephens* case, *supra,* holds that the value at March 1, 1913, should be apportioned between the interests in the property *existing on that date,* even though the lessee of an oil and gas lease may have nothing more than a privilege of extraction. The so-called apportionment clause at the end of subdivision (9) of Section 234(a) merely apportions the "deductions allowed by this paragraph," which means that the deduction of value at March 1, 1913, should be apportioned between the interests existing on that date, and not that the value of the taxpayer's interest on that date, which affords the basis for its deple-

tion deduction, should be reduced or modified on account of the subsequent receipt of income from the property.

C.

The burden-of-proof rule does not extend to the point of requiring the taxpayer to submit evidence upon issues not raised by the Commissioner or involved in the theory of the case shared at the trial by the taxpayer and the Commissioner.

It is believed that a *writ of certiorari* should be granted because the instant case raises grave problems of Board of Tax Appeals practice, affecting millions of taxpayers in the important and often critical matter of tax liability.

On the bonus question the Commissioner, in effect, has been sustained by the Circuit Court of Appeals because of the burden-of-proof rule. *Yet the Commissioner is admittedly allowing erroneous depletion* by deducting the *whole* of the bonus from the capital sum returnable through depletion (R. II-291).

In other words, the tax liability established by the Circuit Court of Appeals decision is admittedly erroneous.

The bonus question was tried before the Board on the issue whether the instrument in connection with which the bonus was paid resulted in a *sale* or a *lease*. This was a true issue, for if the instrument resulted in a *sale*, the Commissioner had correctly reduced the depletable capital sum by the amount of the bonus. That was the issue raised by the Commissioner in his deficiency letter (R. I-18). The taxpayer's petition was an appeal *from that letter* (R. I-6). The letter and the petition and the Commissioner's answer to the petition framed the issue before the Board. The proof was put in on the issue so framed. Months after the

evidence was closed the Commissioner "*confessed error*" in his brief in failing to follow the recently revised edition of Article 215(a) of Regulations 45, and urged the contention that the bonus was only *in part* a return of capital and that depletion should be allocated according to income. The Board of Tax Appeals held that no part of such bonus income was a return of capital so that a taxpayer could under the statute take an allowance for depletion to compensate for a loss of capital. The Circuit Court of Appeals has now reversed the Board without remanding the case for further evidence, which it had the power and was urged to do. The evidence on the bonus question was, therefore, presented on a theory shared by both litigants different from that which afforded the basis of the decision of the Circuit Court of Appeals.

It should be kept distinctly in mind that the taxpayer is not contesting the burden-of-proof rule. It does not need to contest that rule. The taxpayer met the burden of proof before the Board. It completely sustained the burden of proof on the issues as framed by the pleadings. The findings of fact of the Board show (R. I-50) the lease on the Coyote property, the receipt, pursuant to the lease and in addition to the royalties received in oil, of the sum of $5,500,000 in instalments beginning December 31, 1913, and extending to December 1, 1918. The bonus did not "in any wise, depend upon, or relate to production" (R. I-59). Thus, the taxpayer proved all that it was necessary to prove under the issues joined and the Board's decision.

The taxpayer is merely contending that the burden-of-proof rule does not extend beyond the scope of the theory upon which the deficiency is asserted and does not require any introduction of evidence by taxpayers of facts ex-

traneous to the issues as framed by the pleadings. This theory has been recognized by the Board of Tax Appeals in its rules of practice.

Rule 30 provides as follows:

> "The burden of proof shall be upon the petitioner, except as otherwise provided by statute and except that in respect of any new matter pleaded in his answer, it shall be upon the respondent."

Rule 14 provides as follows:

> "The answer shall be so drawn as fully and completely to advise the petitioner and the Board of the nature of the defense. It shall contain a specific admission or denial of each material allegation of fact contained in the petition and a statement of any facts on which the Commissioner relies for defense or for affirmative relief * * *".

The care with which the rules of the Board are drawn so as to prevent surprise at the trial is again illustrated by Rule 18, which provides restrictions upon the filing of amended petitions and gives the Board discretion "at any time before the conclusion of the hearing" to permit a party to amend the pleadings to conform to the proof.

The position of the taxpayer is that the Commissioner's answer did not state the facts upon which the Commissioner relied for defense; that the answer of the Commissioner did not "fully and completely" advise the petitioner of the nature of the defense; that the Commissioner did not even at any time amend his pleadings to conform to the proof, and that the remedy in a case in which the issues are completely changed after the trial of the case is not to give judgment to the Commissioner because the tax-

payer had failed to sustain the burden of proof, but to give an opportunity for further proof in conformity with the reframed issues. In no other way can the Board of Tax Appeals perform its true function which is correctly to determine the amount of the deficiency.

This confusion of theories and issues is a stronger case than was presented in *Underwood* v. *Commissioner*, 56 F. (2d) 67 (C. C. A., 4th) for the taking of further evidence. In that case the parties tried the case on a theory shared by both of them that a certain issue was controlling. In the opinion of the Circuit Court of Appeals that issue was immaterial and the record was deficient in its evidence upon the real issue. The Circuit Court of Appeals for the Fourth Circuit did not give judgment to the Commissioner because the taxpayer had failed to sustain the burden of proof, as the Circuit Court of Appeals for the Ninth Circuit has done in the instant case; it carefully limited the burden-of-proof rule and remanded for further evidence, saying at page 72:

> "The case was tried below upon the assumption, in which both parties shared, that the only question for determination was whether the taxpayer was a state employee or an independent contractor. But this was not correct unless that question should be decided adversely to the Commissioner and he should be directed to exclude from the taxpayer's income the entire sums he received from the State of North Carolina. On the other hand, if it should be decided that the income from the State was taxable, it was still necessary to determine the deductions for ordinary and necessary expenses of the business to be allowed under the Revenue Act of 1924, §214, 43 Stat. 269 (26 U. S. C. A. §955 and note).
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"Notwithstanding this state of affairs, the Commissioner failed to make any allowance for the taxpayer's expenses and assessed the tax on the gross receipts; and this action was affirmed by the Board. The only explanation offered in this court is that the evidence before the Board did not disclose the amount of the expenses incurred; that the burden of proof in a case of this sort is upon the taxpayer and therefore, the Board was obliged to affirm the Commissioner's determination. It is settled that the taxpayer has the burden of proof by a number of decisions of the Supreme Court. *Burnet* v. *Houston,* 283 U. S. 223, 51 S. Ct. 413, 75 L. Ed. 991; *Botany Mills* v. *U. S.,* 278 U. S. 282, 49 S. Ct. 129, 73 L. Ed. 379; *Reinecke* v. *Spaulding,* 280 U. S. 227, 50 S. Ct. 96, 74 L. Ed. 385; *Niles Bement Pond Co.* v. *U. S.,* 281 U. S. 357, 361, 50 S. Ct. 251, 74 L. Ed. 901. But we do not think that this rule so restricts the powers of the Board as to require it to countenance an obvious injustice. 'The Board of Tax Appeals is not a court. It is an executive or administrative board.' *Old Colony Trust Co.* v. *Commissioner,* 279 U. S. 716, 725, 49 S. Ct. 499, 502, 73 L. Ed. 918.

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"The Board had ample power under the statute to require the production of additional evidence when it became clear that it could not do justice to the taxpayer by reason of the deficiencies in the record before it. It was unquestionably incumbent upon the taxpayer to offer the testimony in the first instance, and cases arise where the moving party must suffer the consequences of his own neglect. Here, however, the Board's own opinion showed that the Commissioner's action was wrong in a material respect. The information to correct the mistake was readily obtainable from the same source as that from which the gross receipts of the taxpayer were ascertained.

> Under these circumstances, the Board should have deferred its decision until testimony showing the amount of the deductions to which the taxpayer was entitled was introduced, and then have redetermined the deficiency. The decision of the Board will therefore be reversed and the case remanded in order that the course indicated may be followed."

A case very similar to the instant case is that of the *Alger Sullivan Lumber Co.* v. *Commissioner,* 1932 Commerce Clearing House, Standard Federal Tax Service, paragraph 9194 (C. C. A., 5th)*. The deficiency letter stated that the stock issued to the employees of the taxpayer company was not a bonus; instead the transaction was declared to be a sale to the employees. The issue of whether it was a sale or a bonus was tried before the Board of Tax Appeals. The Board decided that the transaction was a sale (20 B. T. A. 1109). On appeal the Commissioner for the first time raised the question of whether the employees' compensation was reasonable if the stock had been given to them as a bonus. There was no evidence in the record on the question of reasonableness. The Circuit Court of Appeals refused to render judgment for the Commissioner on the ground of failure of proof. It said at page 8588 of the Commerce Clearing House Report:

> "However, it is apparent that the point was not deemed to be material by either petitioner or respondent in the proceedings before the Board and the Board did not consider it. In this situation it would be just and fair to both sides that evidence be admitted on this point and a decision be had upon the question by the Board."

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* Not yet elsewhere reported.

In still another case decided by the Court of Appeals of the District of Columbia (*Dempster Mill Mfg. Co.* v. *Burnet*, 46 F. (2d) 604) a new trial was ordered in the interests of reaching "substantial justice" where the evidence disclosed that the taxpayer had rights but did not fully disclose the extent of those rights. The Board in that case, disregarding the uncontroverted evidence of an interested witness, decided that certain property was without value on March 1, 1913. The Circuit Court of Appeals for the District of Columbia thought there was evidence of value but could not determine the exact value. It therefore said, at page 606:

> "* * * we are of the opinion that substantial justice in this case demands a new trial where the parties can be given an opportunity to adduce such testimony as they may have to offer pertaining to the real issues involved."

Upwards of 17,000 cases are now pending before the Board of Tax Appeals. Many of them have several issues pending. Proof must be submitted on all these issues. The presentation of proof is often a difficult and expensive matter for taxpayers. Justice would seem to require that taxpayers should be protected when they present proof on the issues as framed by the pleadings. All tribunals function most efficiently on this basis; if anything, the practice of the Board, which is not a court, should be more liberal than the practise of the courts. It is one thing to hold that the burden-of-proof rule requires that the taxpayer sustain the burden in proving the issues framed by the pleadings; it is a long step further to require that it submit evidence on all imaginable issues not disclosed in the deficiency letter and answer of the Commissioner to the

petition. This is particularly true where the remedy of taking further evidence is so readily available.

In the state of confusion that exists the simple truth is that this Honorable Court should make some definition, for the information of taxpayers, of the burden-of-proof rule. The propriety of the rule is not being contested on this application; it is being suggested merely that the rule can be carried to utterly unreasonable lengths; it can be made to do more harm than good; it can frustrate, instead of advancing, justice. It is an important matter to taxpayers to know what its limitations are. Where Circuit Courts of Appeals differ it is respectfully urged that this Court should give both government and taxpayers the benefit of its views.

Conclusion.

The essence of the taxpayer's case is simple. It has been shown that a deduction for depletion should be taken only in the years in which depletion is sustained. This is the only true concept of depletion and the only true interpretation of the Revenue Act of 1918. It has also been shown that the bonus payments, which were not dependent upon production, may not be offset by depletion, particularly where the depletion occurs years after the receipt of the payments. It has further been shown that there is no support in the law for the Commissioner's position, and that his amended regulation, approved by the Circuit Court of Appeals, is entirely unjustifiable. The regulation is merely an attempt to legislate and a usurpation of the functions of Congress.

At the beginning of the taxable years involved, 1919 and 1920, the taxpayer had whatever mineral reserve it had

on the basic date, less the amount of minerals actually extracted. Its depletable base, returnable through depletion, was not in fact or in law depleted, lessened, or exhausted by the receipt of the bonus payments. These bonus payments, as the Board held, were by the very terms of the lease made payable unconditionally. They were not in any wise dependent upon extraction or production. It cannot be logically or correctly said that the taxpayer's depletable base was reduced by the receipt of the bonus payments.

Reduced to its real outlines, the regulation in question, Article 215(a), as amended, violates the theory of the statute which gives a depletion allowance on account of "the reduction of the mineral contents of the reserve". All other arguments are extraneous. Arguments as to what should be are irrelevant. The point is: What did Congress provide? This Honorable Court has answered this question. (*Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301). Congress provided in no uncertain terms that depletion should be allowed as a deduction *when sustained.*

It is respectfully urged that this petition should be granted in order that this Honorable Court may affirm the decision of the Board of Tax Appeals herein, and reverse the decision of the Circuit Court of Appeals.

Respectfully submitted,

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